MOBIL OIL CORP.
AND
MOBIL EXPLORATION & PRODUCING SERVICES INC.

IBLA 87-579, 87-750 Decided April 19, 1989

Appeals from decisions by the Director, Minerals Management Service, affirming orders requiring payment of additional royalties and late payment charges. MMS-86-0090, 86-0325, 87-0032, 87-0119-O&G.

Affirmed in part and reversed in part.

1. Oil and Gas Leases: Royalties--Payments: Generally

When Minerals Management Service determines value for royalty purposes, the burden to show error in the determination is on the lessee. Absent a showing of error, the determination of items of cost and revenue to be included in a manufacturing allowance are found to be correct.

2. Oil and Gas Leases: Royalties--Payments: Generally

When a lessee processes gas for recovery of liquid hydrocarbons, pursuant to 30 CFR 206.152 (1986) it must pay royalty either on the value of the wet gas before processing or the value of the residue gas after processing plus the value of the extracted liquids. The value of the liquids may be reduced by a manufacturing allowance which may not exceed two-thirds of the value of the liquids. When calculating the formula to be used for this purpose, it was error to include either the cost or value of processing condensate which was not derived from wet gas produced at the plant.

3. Oil and Gas Leases: Royalties--Payments: Generally

Transportation costs unrelated to the manufacturing process are not properly included in the formulation of a manufacturing allowance to be used in calculating the royalty value of natural gas.

4. Oil and Gas Leases: Royalties--Payments: Generally

When formulating a manufacturing allowance for purposes of calculating royalty, an allowance for expenses incidental to marketing ethane gas was properly denied. When calculating royalty pursuant to 30 CFR 206.150 1986), the value of production shall not be less than fair market value, nor less than gross proceeds accruing from disposition of produced gas.

APPEARANCES: W. R. Buck, Esq., Dallas, Texas, for appellants; Peter J. Schaumberg, Esq., Geoffry Heath, Esq., Howard W. Chalker, Esq., Office of the Solicitor, United States Department of the Interior, Washington, D.C., for Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE ARNESS

Superior Oil Company operates the Lowry Gas Processing Plant in Louisiana through its agents Mobil Oil Corporation and Mobil Exploration and Producing Services, Inc. (hereafter, collectively "Mobil"). From 1977 until 1982 the Lowry plant refined natural gas from seven Federal outer continental shelf (OCS) 1/ leases held by Mobil. The Lowry facility also refined gas received from other lessees who held no interest in the Lowry plant. Such users paid for refining by allowing Mobil to retain a percentage of the petroleum liquids produced by the plant.

On January 14, 1986, following review of Lowry royalty payments from January 1977 through December 1982, Minerals Management Service (MMS) ordered Mobil to recalculate and pay additional royalties to reflect adjustments to expenses and revenues from the plant arising from computation of the manufacturing allowance for liquids extracted from gas. Acting in compliance with this order, Mobil paid additional royalties of $260,812.74,
and filed administrative appeal MMS-86-0090-O&G with the Director, MMS. On May 2, 1986, Mobil was assessed late payment charges of $230,307.09 for the additional royalty payment so made. Mobil appealed from this assessment in administrative appeal MMS-87-0032-O&G.

On December 1, 1986, MMS ordered Mobil to pay $2,896.09 in additional royalties for failure to correctly value ethane gas produced at the Lowry plant. Mobil also appealed from that order, in appeal MMS-87-0032-O&G. A subsequent appeal from an assessment of late interest charges for the ethane royalty was consolidated with Mobil's appeal from the additional royalty payment.

Mobil's appeals were consolidated for consideration by the Director, MMS, who, on April 27, 1987, affirmed the various assessments as made, with

1/ Although these leases are apparently OCS leases, the case files are designated "O&G."

some exceptions not material to this appeal. On appeal to this Board from the Director's decisions, the authority of MMS to make late payment charges is not directly challenged, although the validity of the underlying assessments is denied. Also, Mobil has now abandoned an argument concerning whether allowance should be made for supervisory salaries when calculating operating expenses. We therefore first consider issues raised concerning the manufacturing allowance given the Lowry plant for the seven OCS leases for which royalties were ordered recomputed.

When a Federal lessee refines gas for the recovery of constituent hydrocarbon products, it must pay royalty on either the value of the gas before refining, or the value of residue gas and the products extracted by the refining process, whichever is higher. 30 CFR 206.152 (1986). In this case, Mobil, a Federal lessee, holds an interest in the refinery where the gas is processed, and a manufacturing allowance is used by MMS to permit calculation of the royalty due on processed gas, so that the royalty computation required by 30 CFR 206.152 can be made. This manufacturing allowance may not exceed two-thirds of the value of the liquids produced. Id. The allowance is subject to audit by MMS. It was such an audit of the Lowry refinery for Mobil's seven OCS leases which led to these appeals now under review.

In calculating the manufacturing allowance for the Lowry plant, a formula was used by MMS. The components of the formula relevant here include liquid sales value, operating expenses, and depreciation. The formula is used to derive a factor representing the allowable deduction from royalty. MMS explains, by use of an example, "an allowance decimal of .385 means that for a liquid having a market value of $.90, $.3465 (.385 x $.90) represents the cost of processing that liquid" (MMS Memorandum to Chief, Division of Appeals, dated June 1986). Mobil has not challenged this formula, which we accept at face value.

Mobil does, however, challenge the refusal by MMS to include certain costs and exclude some revenues when making computations using the formula. Mobil, therefore, seeks to justify the royalties it paid on natural gas liquid products from its Federal OCS leases by showing that it should not have been required to recompute some of its manufacturing costs. As Mobil explains, it

> is entitled to deduct a manufacturing allowance from the value of its products for the purpose of calculating royalties. The formula for calculating this allowance is dependent upon three variables: 1) income on gross liquids; 2) operating expenses; and 3) depreciation. The means of calculating these variables is at issue.

(Statement of reasons (SOR) at 3).

The challenge to components of the manufacturing allowance formula raised by Mobil's appeal presents questions about which plant revenues and costs should be used to determine the manufacturing allowance by which the value subject to royalty may be reduced. We begin with Mobil's argument that gas belonging to lessees who own no interest in the Lowry plant (from whom Mobil collects a processing fee in kind)should not be considered to be income producing, even though such gas is processed at Lowry.

[1] Mobil concedes it must include in the computation of liquid sales value all income from liquids produced by gas coming out of its own leases. It contends, however, that revenue from liquids obtained from lessees who own no interest in the Lowry plant should include only those substances in which Mobil has an interest; that is, only the percentage of liquids retained by Mobil in payment for refining should be included for royalty calculation.

MMS has responded to Mobil's argument with this analysis:

> The effect of Mobil's argument would be to use 100% of the plant costs (including operating expenses and depreciation) in the formula but only part of the gas for the processing of which those costs were incurred; in other words, Mobil's formulation allocates the entire plant cost only to the portion of the liquids which Mobil owns. The result is to ascribe to those liquids a higher cost of processing than what is actually incurred. The costs properly attributable to the non plant owner's gas which Mobil processes are covered by the 20% share of the gas which Mobil retains as its "fee" and on which no royalty is assessed. Thus Mobil's formulation artificially inflates the processing costs attributable to its gas and thereby artificially reduces the proper royalty due on the extracted liquids. * * * [A] manufacturing allowance based on all processing costs must also be based on * * * all liquid values.

(Answer at 5).

We agree that were MMS to allocate all the costs of operating the plant against only part of the liquids produced by the plant it would distort the true cost of production of each unit of the substances produced. So limiting the revenues of the plant would inflate the cost to produce each unit of liquid considered, since only retained liquids would be considered to produce revenue. The costs incurred to refine gas for non-owner producers would however, continue to be included in total plant costs. This would inevitably reduce royalty, since it would decrease the apparent value of production from the plant by increasing the cost of manufacturing for all units produced.

While Mobil has argued that it would be unfair to consider the entire production of the Lowry plant for purposes of calculating plant revenue, it has not shown how such a method of calculation would accurately depict the actual cost to produce a unit of liquid for purposes of calculating the plant's manufacturing allowance. A challenge to valuation by MMS of hydrocarbons produced from a Federal lease must show how the method of calculation is in error. Amoco Production Co., 85 IBLA 121 (1985); Amoco Production Co., 78 IBLA 93 (1983). Mobil has failed to show how a formula used to calculate a manufacturing allowance which includes all processing costs can reasonably recognize only part of the liquid production obtained.

[2] Mobil next contends that fractionation at Lowry of condensate into diesel should not be taken into consideration in calculating the manufacturing allowance for the plant. Mobil suggests that "[f]irst, little or no economic benefit was derived * * * from this process. Because the condensate was readily marketable without fractionation, the conversion added little, if any, value. Secondly, the condensate was not in the natural gas processed and, therefore, should not be considered in the revenue section" (SOR at 5). Mobil concludes, consequently, that the value of diesel fractionated from condensate at the Lowry plant should not be included as income from gross liquids by MMS for royalty purposes.

Mobil does not deny that condensate was fractionated into diesel at Lowry. It states, however, and MMS has not disagreed, that the condensate did not originate in natural gas processed in the plant. When condensate was refined at Lowry to produce diesel, some costs were necessarily incurred in the process. MMS submits that if those costs are not to be excluded from the calculation of the manufacturing allowance for the Lowry facility, then the value of the diesel production must also be considered for purposes of formulating the plant's manufacturing allowance, because not to do so would inflate the cost of manufacturing and weight the manufacturing allowance in the lessee's favor.

The fallacy of MMS' position is that it assumes the formula for calculating the manufacturing allowance should include this item of production in the liquid sales value from the Lowry plant, even though it did not originate from the wet gas processed at the plant. There is no apparent foundation for including the value of diesel production in the calculation of the manufacturing formula to be used by MMS for valuation of the wet gas processed at Lowry. Logically, since the condensate used to fractionate diesel was not derived from the wet gas processed at the Lowry plant, it should not be included in the calculation of the manufacturing allowance for valuation of the Lowry gas. Thus, both the cost of manufacturing the diesel and the value of the diesel are properly excluded from the calculation of the manufacturing allowance, since this item of production is unrelated to the gas to be valued for royalty purposes. The contrary finding by MMS is therefore reversed.

[3] The treatment given by MMS to several expenditures Mobil claimed as operating expenses includable in the allowance is also objected to by Mobil. First, Mobil seeks to include barge loading dock expenses in plant operating costs, contending that such expenses are "an integral part of the Plant operation" (SOR at 7). This argument overlooks the rule that a Federal lessee is obligated to bear the costs of putting oil or gas in marketable condition. The California Co., 66 I.D. 54 (1959), aff'd California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961). Transportation and storage

costs incurred after processing is complete may not be included, therefore, as a factor in developing a manufacturing allowance, because they are not part of processing, an action which can take place only at Lowry. See and compare Petro-Lewis Corp., 108 IBLA 20, 96 I.D. _ (1989). While costs of transporting oil or gas to the point of first sale are separately deductible as a transportation allowance (id. at 35), and barging costs may qualify as a transportation allowance (Shell Oil Co., 70 I.D. 393 (1963)), there is no evidence that the barging costs here claimed by Mobil were for transportation from the field to point of first sale.

While Mobil denies that barge costs are necessary to place gas in a marketable condition, it has offered no reason to question the finding by MMS on this issue. Barge costs may not be included in the manufacturing allowance as part of the cost of operating the Lowry plant, absent a show-ing that they are part of the processing operation. No such showing has been made. It is apparent such costs are related to the transportation of the gas, 2/ not to the manufacturing process itself. See California Co. v. Udall, supra at 296 F. 2d 387.

Mobil also disagrees with the requirement imposed by MMS that, in computing the Lowry manufacturing allowance, Mobil capitalize some improve-ments made to the Lowry plant which it had treated as current expenses for repairs. The effect of this requirement was to spread the expenditures over a much longer period in the form of depreciation, thereby reducing the immediate effect of these expenses on the manufacturing allowance. A major part of this expense was incurred to overhaul compressors and a generator at a cost exceeding 60 percent of the cost of the original equipment. MMS explained the reason for disallowing these and similar items with the following comment:

> In question are certain "authorizations for expenditures (AFE's)" that Appellant expensed as maintenance and repairs. The audit disclosed 13 AFE's totalling $469,012.86 that were expensed by Appellant but should have been capitalized. Other than the AFE's Appellant agrees should have been capitalized, the expenditures are considered by Appellant or the MMS to be overhauls. Over-hauls, sometimes referred to as renewals, are extraordinary repairs that prolong the equipment's useful life, thereby benefitting several future periods. The overhaul cost, therefore, should be allocated to those future periods. [Emphasis in original.]

(MMS Memorandum to Chief, Division of Appeals, dated June 9, 1986, at 5).

2/ MMS indicates that these costs were incurred prior to processing (Answer at 7). This strikes the Board as improbable. Mobil refers to barge facilities "as necessary to move the product" (SOR at 7), suggesting the more likely scenario that the barge costs followed rather than preceded processing. Under either circumstance, such costs may not be deemed incidental to manufacturing.

While Mobil disagrees with this analysis of the nature of the repairs made to its Lowry plant, it gives no reason for disagreement except to assert that the "overhauls challenged by MMS did not extend the useful life or improve the operation of the equipment beyond design specifications" (SOR at 8). As MMS points out, however, the approach to capitalization described by Mobil seems not unlike the policy announced by MMS. That policy requires capitalization of expenses likely to extend the useful life of an individual asset. Despite the similarity of the principles endorsed by both parties, Mobil attacks the reasoning used by MMS, responding that it "is insufficient justification for the requirement that these expenditures be capitalized and depreciated rather than expensed." Id.

Mobil does not explain how the MMS conclusion with which it disagrees was in error. It has the burden to do so on appeal, or its arguments must fail. Amoco Production Co. supra. Because we must therefore reject Mobil's argument that these repairs were not capital asset improvements, Mobil is required to recalculate depreciation expenses in compliance with the order by MMS that it do so.

[4] Turning to the contention by Mobil that MMS incorrectly valued ethane gas produced at Lowry, Mobil explains that ethane could not be sold at Lowry at the time it was produced. An exchange was therefore arranged with Exxon for a like quantity of ethane at Mt. Belvue, where a market existed. The Mt. Belvue gas was then sold. MMS figured royalty for Mobil's ethane on the price paid for the Mt. Belvue gas. Mobil argues that royalty value should instead be based on a value assigned to gas at the Lowry plant, or, in the alternative, that Mobil should be allowed to deduct the cost of movement, storage, and sale of the Mt. Belvue gas from the price received for purposes of royalty calculation.

This argument ignores the requirement of 30 CFR 206.150 that "[t]he value of production shall never be less than the fair market value."
Mobil has offered no evidence to show that fair market value was some other value than the price it received for the Mt. Belvue gas. Since there was
no market at Lowry for similar gas, there is no basis for assuming a mar- ket value at Lowry, at a lower price than the price actually received for the Mt. Belvue gas. Nor may the costs of sale of the Mt. Belvue gas be deducted from the royalty value established by the Mt. Belvue sale. The value of production for royalty purposes cannot be less than the gross proceeds accruing to a lessee from disposition of produced substances. 30 CFR 206.150. To allow Mobil to deduct costs of sale of the Mt. Belvue gas would reduce the sale price to a net figure, contrary to the rule established by 30 CFR 206.150.

Further, Departmental regulation prohibits allowance for expenses incidental to marketing when calculating royalty on processed gas and constituent products. Pertinently, 30 CFR 206.152(d) provides that "[n]o allowance shall be made for * * * expenses incidental to marketing." Mobil's request for allowance of costs of marketing ethane gas was properly denied.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decisions appealed from are affirmed in part and reversed in part.

Franklin D. Arness
Administrative Judge

I concur:

Wm. Philip Horton
Chief Administrative Judge